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Checklist supplement and illustrative financial statements for construction contractors : a financial accounting and reporting practice aid, August 1992 edition

American Institute of Certified Public Accountants. Technical Information Division

Martin S. Safran

August 1992 Edition

Checklist Supplement and Illustrative Financial Statements for Construction Contractors

A FINANCIAL ACCOUNTING AND REPORTING PRACTICE AID

To be used in conjunction with *Checklists and Illustrative Financial Statements for Corporations*

Edited by

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Checklist Supplement and Illustrative Financial Statements for Construction Contractors has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the American Institute of Certified Public Accountants or the Financial Accounting Standards Board and has no official or authoritative status.

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CHECKLIST SUPPLEMENT AND ILLUSTRATIVE FINANCIAL STATEMENTS FOR CONSTRUCTION CONTRACTORS

The checklist supplement and illustrative financial statements are <u>not</u> designed to be applied to the financial statements of government contractors or governmental units.

The checklist supplement and illustrative financial statements included in this publication have been developed by the staff of the Technical Information Division of the AICPA as a nonauthoritative technical practice aid. Readers should be aware of the following:

- The checklist supplement and illustrative financial statements are "tools" and in no way represent official positions or pronouncements of the AICPA.

- The checklist supplement and illustrative financial statements are to be used in conjunction with the "Checklists and Illustrative Financial Statements for Corporations," and have been updated to include relevant accounting pronouncements through FASB Statement of Financial Accounting Standards No. 109, FASB Interpretation No. 39, AICPA Accounting Principles Board Opinion No. 31, AICPA Accounting Research Bulletin No. 51, FASB Technical Bulletin No. 90-1, AICPA Accounting Standards Division Statement of Position No. 92-1 and AICPA Practice Bulletin No. 9; AICPA Audit and Accounting Guide, *Construction Contractors* (1981); and FASB Emerging Issues Task Force consensuses reached through March 19, 1992. The checklist supplement and illustrative financial statements should be modified, as appropriate, for subsequent pronouncements. In determining the applicability of a pronouncement, its effective date should also be considered.

- The checklist supplement and illustrative financial statements should be used by or under the supervision of persons having adequate technical training and proficiency in the application of generally accepted accounting principles, generally accepted auditing standards and statements on standards for accounting and review services.

- The checklist supplement and illustrative financial statements do not represent minimum requirements and do not purport to be all-inclusive. The referenced standards should be reviewed if clarification is desired as to whether the disclosures indicated are required or suggested, and to what extent the disclosure is relevant to the statements being audited, reviewed or compiled.

Users of the checklist supplement and illustrative financial statements are urged to refer directly to applicable authoritative pronouncements when appropriate. If you have further questions, call the AICPA Technical Hotline (see back cover). The author wishes to acknowledge the assistance of his colleague, Michael A. Tursi, CPA, who served as consultant on this project.

Susan Menelaides
Director
Technical Information

CHECKLIST SUPPLEMENT AND ILLUSTRATIVE FINANCIAL STATEMENTS FOR CONSTRUCTION CONTRACTORS

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INTRODUCTION

The growth in the U.S. economy has produced a variety of construction type contracts and types of business enterprises that use them.

The organizational structure, resources and capabilities of contractors tend to vary with the type of construction activity.

Common accounting and reporting practices by contractors include the following:

- The predominant practice is to present balance sheets with assets and liabilities classified as current and noncurrent on the basis of one year or the operating cycle. An unclassified balance sheet is also acceptable.
- Costs and estimated earnings in excess of billings are classified as current assets, and billings in excess of costs and estimated earnings are classified as current liabilities.
- Net debit balances for certain contracts should not be offset against net credit balances of other unrelated contracts.
- Contractors frequently participate in joint ventures, corporations and general or limited partnerships. These may be reported as investments or combined or consolidated in the financial statements.
- The percentage-of-completion method of contract accounting is preferable, but the completed-contract method is also acceptable.
- The method of revenue recognition should be disclosed.
- A provision for losses on a contract should be made as soon as the losses become evident, regardless of the method of accounting for the contract, and reported as a liability or deducted from any related accumulated costs.
- Contractors are encouraged to present backlog information.

Financial Statements and Notes Checklist Supplement for Construction Contractors

This checklist supplement has been developed by the staff of the Technical Information Division of the AICPA as a nonauthoritative practice aid, and is to be used in conjunction with the "Checklists for Corporations." Accordingly, the notice on pages iii and iv is incorporated herein by reference.

Explanation of References:

AC	=	Section in FASB *Accounting Standards - Current Text*
APB	=	AICPA Accounting Principles Board Opinion
ARB	=	AICPA Accounting Research Bulletin
CC	=	AICPA Audit and Accounting Guide, *Construction Contractors* (1981)
SFAS	=	FASB Statement of Financial Accounting Standards
SOP	=	AICPA Statement of Position
TPA	=	Section in AICPA *Technical Practice Aids*

Checklist Questionnaire

	YES	NO	N/A
General			
A. Accounting Policies			
1. Is the method of reporting affiliates disclosed relative to the following:			
a) The consolidation policy when consolidated statements [required if the reporting entity has nontemporary direct or indirect financial control over another entity] are presented? [SFAS 94, par. 13 and ARB 51, par. 5 (AC C51.103 and .108)]	___	___	___
b) Investments in joint ventures? [CC, Ch. 6, p. 52]	___	___	___
c) Other affiliates? [CC, Ch. 6, p. 51]	___	___	___
2. If the operating cycle exceeds one year, is the range of contract durations disclosed?	___	___	___

YES NO N/A

3. Disclosure of method of revenue recognition:

   a) If the percentage-of-completion method is used, is the method of computing percentage of completion (e.g., cost to cost, labor hours) disclosed? ___ ___ ___

   b) If the completed-contract method is used:

      (1) Is the basis of selecting that method disclosed? ___ ___ ___

      (2) Are the criteria employed to determine substantial completion disclosed? ___ ___ ___

   c) Where applicable, is the policy with respect to combining or segmenting contracts disclosed? ___ ___ ___

   d) In those instances where the basic accounting policy is percentage-of-completion and the completed-contract method is used for a single contract or group of contracts, because the criteria for the use of percentage-of-completion are not present, is such a departure from the basic policy disclosed? ___ ___ ___

   [CC, Ch. 6, pp. 51-52; SOP 81-1, pars. 21, 25, 45, and 52]

   e) Was the policy for recognition of revenue or deferral of costs related to back charges or claims for additional contract compensation disclosed? ___ ___ ___

   f) Was the policy on revisions in revenue, costs, and profit estimates or in measurements of the extent of progress toward completion disclosed (i.e., cumulative catch-up or reallocation)? ___ ___ ___

   [CC, Ch. 2, p. 25; SOP 81-1, par. 84]

4. (Reserved)

YES **NO** **N/A**

5. Is the following contract cost information disclosed:

   a) The aggregate amount included in contract costs representing unapproved change orders, claims, or similar items subject to uncertainty concerning their determination or ultimate realization, plus a description of the nature and status of the principal items comprising such aggregate amounts and the basis on which such items are recorded (for example, cost or realizable value)? ___ ___ ___

   b) The amount of progress payments netted against contract costs at the date of the balance sheet? ___ ___ ___

   c) The types of contract costs? ___ ___ ___

   d) Where there are fees recognized from construction management contracts where the contractor acts solely in the capacity of an agent, has disclosure of the volume of subcontracts and materials contracts entered into been considered in the notes to the financial statements? ___ ___ ___

   e) Where there is a provision for loss on a contract and it is material in amount or unusual or infrequent in nature, is the loss shown separately as a component of cost included in the computation of gross profit? ___ ___ ___

   [CC, Ch. 6, p. 52; SOP 81-1, pars. 65-66, 69-72, and 88]

6. For costs deferred either in anticipation of future sales (precontract costs) or as a result of an unapproved change order, are the policy of deferral and the amounts involved disclosed? ___ ___ ___
   [CC, Ch. 6, p. 52]

YES NO N/A

B. Accounting Changes

1. Are significant revisions in estimates of the percentage of completion disclosed if the effects are material? ___ ___ ___
[CC, Ch. 6, p. 52; SOP 81-1, pars. 82-84; APB 20, par. 33 (AC A06.132)]

2. For special changes requiring restatement, such as changes in long-term construction contract reporting, are the following disclosed:

a) Nature of the change? ___ ___ ___

b) Justification for the change? ___ ___ ___

c) Effect on income (and earnings per share, if applicable) in the period of the change for all periods presented? ___ ___ ___
[APB 20, pars. 27-28 and 45-48 (AC A06.123-.124 and A35.114-.119)]

C. Related-Party Transactions and Economic Dependency

1. If there are affiliated members of a group under common control whose operations are closely interrelated and economically interdependent, are combined financial statements presented, unless consolidated financial statements are appropriate under ARB 51 and SFAS 94? ___ ___ ___
[CC, Ch. 4, p. 38]

2. If combined financial statements are presented, is the following information disclosed:

a) A statement to the effect that the statements are not those of a separate legal entity? ___ ___ ___

b) The names and year-ends of the major entities included in the combined group? ___ ___ ___

	YES	NO	N/A
c) The nature of the relationship between the companies?	___	___	___
d) The capital of each entity, either in detail by entity if the number of entities is small or, if detailed disclosure is not practicable, in condensed form with an explanation as to how the information was accumulated?	___	___	___
[CC, Ch. 4, p. 38]			

D. Contingencies and Commitments

1. Disclosure of backlog information is encouraged:

a) Is backlog information for signed contracts on hand whose cancellations are not anticipated, disclosed?	___	___	___
b) Is backlog information for letters of intent disclosed?	___	___	___
• If so, is it reported separately from (a) above?	___	___	___
[CC, Ch. 6, pp. 52-53]			
2. Have state statutes affecting construction contractors been considered?	___	___	___
[CC, Ch. 11, p. 100]			

3. If the reporting entity has retail land sales operations, are the following disclosed regarding improvements:

a) For major sales areas for each of the next five years:

(1) Estimated total costs?	___	___	___
(2) Estimated expenditures?	___	___	___
b) Recorded obligations?	___	___	___
[SFAS 66, par. 50 (AC Re1.150)]			

YES NO N/A

E. Interest Costs

- Interest costs should be capitalized for long-term construction contracts. Is the total interest capitalized disclosed for each period presented? [SFAS 34, par. 21 (AC I67.118)] ___ ___ ___

Balance Sheet

A. General

1. Was a classified balance sheet considered if the operating cycle is one year or less? [CC, Ch. 6, p. 45] ___ ___ ___

2. If the operating cycle exceeds one year an unclassified balance sheet is preferable. However, if in management's opinion an unclassified balance sheet would not result in a meaningful presentation, are the following contract-related items generally classified as current under the operating cycle concept:

   a) Contract-related assets:

      (1) Accounts receivable on contracts (including retentions)? ___ ___ ___

      (2) Unbilled contract receivables? ___ ___ ___

      (3) Costs in excess of billings and estimated earnings? ___ ___ ___

      (4) Other deferred contract costs? ___ ___ ___

      (5) Equipment and small tools specifically purchased for, or expected to be used solely on, an individual contract? ___ ___ ___

   b) Contract-related liabilities:

      (1) Accounts payable on contracts (including retentions)? ___ ___ ___

	YES	NO	N/A
(2) Accrued contract costs?	___	___	___
(3) Billings in excess of costs and estimated earnings?	___	___	___
(4) Deferred taxes resulting from the use of a method of income recognition for tax purposes different from the method used for financial reporting purposes?	___	___	___
(5) Advance payments on contracts for mobilization or other purposes?	___	___	___
(6) Obligations for equipment specifically purchased for, or expected to be used solely on, an individual contract regardless of the payment terms of the obligations?	___	___	___
(7) Provisions for losses on contracts (except in circumstances in which related costs are accumulated on the balance sheet, in which case the provision may be deducted from the related accumulated costs)?	___	___	___

[CC, Ch. 6, pp. 45-48; SOP 81-1, par. 89]

B. Receivables

1. Are the nature and status of billed or unbilled amounts included in receivables representing unapproved change orders, claims, or similar items subject to uncertainty disclosed, including amounts to be collected after one year?	___	___	___
2. Are amounts in receivables representing the recognized sales value of performance under contracts in which the amounts have not been billed and are not billable to customers at the balance sheet date disclosed with a general description of the prerequisite for billing?	___	___	___
• Are the amounts to be collected after one year disclosed?	___	___	___

[CC, Ch. 6, p. 53; SOP 81-1, par. 65]

	YES	NO	N/A
3. If it is not probable that a claim will result in additional contract revenue or if the amount cannot be reliably estimated, has disclosure of a contingent asset been considered?	___	___	___
• If such a gain contingency is disclosed, does the wording avoid misleading implications as to the likelihood of realization?	___	___	___
[CC, Ch. 6, p. 53; SOP 81-1, par. 67; SFAS 5, par. 17 (AC C59.118)]			
4. If revenue from claims is recorded only when the amounts have been received or awarded, is the aggregated amount of such claims disclosed?	___	___	___
[SOP 81-1, par. 66]			
5. If receivables include amounts maturing after one year, are the following disclosed:			
a) The amount maturing after one year and, if practicable, the amounts maturing in each year?	___	___	___
b) Interest rates on major receivable items, or on classes of receivables, maturing after one year or an indication of the average interest rate or the range of rates on all receivables?	___	___	___
[CC, Ch. 6, pp. 53-54]			
6. If receivables include amounts representing balances billed but not yet paid by customers under retainage provisions, is disclosure made of the amounts included, the amounts expected to be collected after one year and, if practicable, the years in which the amounts are expected to be collected?	___	___	___
[CC, Ch. 6, p. 54]			
7. Are retentions receivable not due within the company's operating cycle classified as noncurrent in a classified balance sheet?	___	___	___
[CC, Ch. 6, pp. 48 and 54]			

	YES	NO	N/A
8. For receivables from retail land sales operations, are the following disclosed:			
a) Maturities for each of the next five years?	___	___	___
b) Delinquent amounts and methods of determination?	___	___	___
c) Weighted average and range of stated interest rates? [SFAS 66, par. 50 (AC Re1.150)]	___	___	___

C. Investments

	YES	NO	N/A
1. Have the following disclosures relating to significant joint ventures been considered:			
a) The name of each joint venture, the percentage of ownership, and any important provisions of the joint venture agreement?	___	___	___
b) If the joint venture's financial statements are not fully consolidated with those of the venturer, separate or combined financial statements of the ventures in summary form, including disclosure of accounting principles of the ventures that differ significantly from those of the venturer?	___	___	___
c) Intercompany transactions during the period and the basis of intercompany billings and charges?	___	___	___
d) Liabilities and contingent liabilities arising from the joint venture arrangement? [CC, Ch. 3, p. 36]	___	___	___
e) Other appropriate disclosures for real estate venture and equity method investments? [SOP 78-9, par. 12 (TPA 10240.12) and APB 18, par. 20 (AC I82.110)]	___	___	___

	YES	NO	N/A
2. Is an investment in a joint venture which is presented on the cost or equity method classified as noncurrent unless the venture is expected to be completed and liquidated during the current operating cycle? [CC, Ch. 6, p. 48]	___	___	___
3. Are losses in excess of an investment in a joint venture presented as a liability? [CC, Ch. 6, p. 49]	___	___	___

D. Property and Equipment

• Is equipment acquired for a specific contract that will be used only on that contract and will be consumed during the life of the contract or disposed of at the conclusion of the contract classified as a contract cost? [CC, Ch. 6, p. 49]	___	___	___

E. Current Liabilities

1. Are the following disclosures made for billings in excess of cost and estimated earnings:

a) If costs exceed billings on some contracts, and billings exceed costs on others, are the contracts segregated so that figures on the asset side include only those on which costs exceed billings, and those on the liability side include only those on which billings exceed costs?	___	___	___
b) Are billings and related costs presented separately either by short extension of the amounts on the balance sheet or in the notes to the financial statements?	___	___	___
c) Are billings in excess of costs and estimated earnings classified as a current liability, except to the extent billings exceed total estimated costs at completion of the contract plus contract profits earned to date, in which case are they classified as deferred income?	___	___	___

[CC, Ch. 6, pp. 49-51]

	YES	NO	N/A

F. Other Liabilities and Deferred Credits

1. Is retentions payable not due within the company's operating cycle classified as noncurrent in a classified balance sheet? [CC, Ch. 6, p. 48] ___ ___ ___

2. Are the disclosures and classifications appropriate regarding the income tax effects of the following:

   a) Differences between financial and tax reporting of long-term construction contracts? ___ ___ ___

   b) Investments in joint ventures and partnerships? ___ ___ ___

   [SFAS 109 (AC I27); SFAS 96 as amended (AC I25); or APB 11 as amended (AC [app. E] I28, I37 and I42)]

Supplemental Disclosures for Construction Contractors

- Has the following supplementary information been considered by contractors using the percentage-of-completion method:

  1. Earnings from contracts? ___ ___ ___

  2. Contracts completed? ___ ___ ___

  3. Contracts in progress? ___ ___ ___

  [CC, App. 7, pp. 196-198]

Illustrative Financial Statements

ILLUSTRATIVE FINANCIAL STATEMENTS
Percentage of Completion

(The following reports of the independent CPA and financial statements illustrate several styles of currently acceptable practice. The CPA should be guided by existing auditing standards concerning the report. Other forms of financial statements are acceptable. More or less detail should appear in the financial statements or in the notes depending on the circumstances.)

Independent Auditor's Report

To the Board of Directors and Stockholders
Percentage Contractors, Inc.

We have audited the accompanying consolidated balance sheets of Percentage Contractors, Inc. as of December 31, 19X8 and 19X7, and the related statements of income and retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Percentage Contractors, Inc. as at December 31, 19X8 and 19X7, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*City, State*]*
February 18, 19X9

*Optional for non-public companies.

Percentage Contractors, Inc.
Consolidated Balance Sheets

December 31, 19X8 and 19X7

Assets	19X8	19X7
Cash and cash equivalents (including certificates of deposit of $40,300 in 19X8)	$ 304,400	$ 221,300
Contract receivables (Notes 2 and 16)	3,789,200	3,334,100
Costs and estimated earnings in excess of billings on uncompleted contracts (Notes 3 and 16)	80,200	100,600
Inventory, at lower of cost, on a first-in, first-out basis, or market	89,700	99,100
Prepaid charges and other assets (Note 11)	118,400	83,200
Advances to and equity in unconsolidated joint venture (Note 4)	205,600	130,700
Note receivable, related company (Note 5)	175,000	150,000
Property and equipment, net of accumulated depreciation and amortization (Note 6)	976,400	1,019,200
	$5,738,900	$5,138,200

Liabilities and Shareholders' Equity		
Notes payable (Note 8)	$ 468,100	$ 578,400
Lease obligations payable (Note 9)	197,600	251,300
Accounts payable (Note 7)	2,543,100	2,588,500
Billings in excess of costs and estimated earnings on uncompleted contracts (Notes 3 and 16)	242,000	221,700
Accrued income taxes payable	52,000	78,600
Other accrued liabilities	36,600	36,000
Minority interests in consolidated joint venture	154,200	26,200
Deferred income taxes (Note 13)	619,200	408,000
	4,312,800	4,188,700
Commitments and contingencies (Notes 2, 10, 11, 14 and 16)		
Shareholders' equity		
Common stock—$1 par value, 500,000 authorized shares, 300,000 issued and outstanding shares	300,000	300,000
Retained earnings	1,126,100	649,500
Total shareholders' equity	1,426,100	949,500
	$5,738,900	$5,138,200

The accompanying notes are an integral part of these financial statements.

Percentage Contractors, Inc.
Consolidated Statements of Income and Retained Earnings

Years Ended December 31, 19X8 and 19X7

	19X8	19X7
Contract revenues earned (Notes 12 and 16)	$22,554,100	$16,225,400
Cost of revenues earned	20,359,400	14,951,300
Gross profit	2,194,700	1,274,100
Selling, general, and administrative expenses	895,600	755,600
Income from operations	1,299,100	518,500
Other income (expense)		
Equity in earnings from unconsolidated joint venture (Note 4)	49,900	5,700
Gain on sale of equipment	10,000	2,000
Interest expense (net of interest capitalized and interest income of $25,600 and $8,800 in 19X8 and $11,600 and $6,300 in 19X7)	(69,500)	(70,800)
	(9,600)	(63,100)
Income before income taxes	1,289,500	455,400
Provision for income taxes (Note 13)	662,900	225,000
Net income (per share, $2.09 (19X8); $.77 (19X7))	626,600	230,400
Retained earnings, beginning of year	649,500	569,100
Less: Dividends paid (per share, $.50 (19X8); $.50 (19X7))	(150,000)	(150,000)
Retained earnings, end of year	$ 1,126,100	$ 649,500

The accompanying notes are an integral part of these financial statements.

Percentage Contractors, Inc.
Consolidated Statements of Cash Flows
(Indirect Method)

Years Ended December 31, 19X8 and 19X7
Increase (Decrease) in Cash and Cash Equivalents

	19X8	19X7
Cash flows from operating activities		
Net income	$ 626,600	$ 230,400
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	167,800	153,500
Gain on sale of equipment	(10,000)	(2,000)
Minority interest in earnings from consolidated joint venture	128,000	26,200
Equity in earnings from unconsolidated joint venture	(49,900)	(5,700)
Deferred income taxes	211,200	(75,900)
Increase in contract receivables, less provision for losses of $35,000 in 19X8 and $30,000 in 19X7	(455,100)	(9,100)
Net increase in billings related to costs and estimated earnings on uncompleted contracts	40,700	10,500
Decrease (increase) in inventory	9,400	(3,600)
Decrease (increase) in prepaid charges and other assets	(35,200)	16,100
Increase (decrease) in accounts payable	(45,400)	113,200
Decrease in accrued income taxes payable	(26,600)	(2,400)
Increase in other accrued liabilities	600	21,200
Net cash provided by operating activities	562,100	472,400
Cash flows from investing activities (Note 15)		
Proceeds from equipment sold	25,000	5,000
Acquisition of equipment	(140,000)	(175,000)
Advances to unconsolidated joint venture	(25,000)	(9,700)
Increase in note receivable, related company	(25,000)	(50,000)
Net cash used in investing activities	(165,000)	(229,700)
Cash flows from financing activities (Note 15)		
Principal payments on notes payable	(110,300)	(90,300)
Principal payments under capital lease obligation	(53,700)	(9,700)
Cash dividends paid	(150,000)	(150,000)
Net cash used in financing activities	(314,000)	(250,000)
Net increase (decrease) in cash and cash equivalents	83,100	(7,300)
Cash, beginning of year	221,300	228,600
Cash and cash equivalents, end of year	$ 304,400	$ 221,300

The accompanying notes are an integral part of these financial statements.

Supplementary data:

Cash equivalents include certificates of deposit purchased with maturities of one to three months.

	19X8	19X7
Interest paid	$80,700	$77,800
Income taxes paid	$478,300	$303,300

Percentage Contractors, Inc.
Notes to Consolidated Financial Statements

Years Ended December 31, 19X8 and 19X7

1. Significant Accounting Policies

Company's activities and operating cycle. The Company is engaged in a single industry: the construction of industrial and commercial buildings. The work is performed under cost-plus-fee contracts, fixed-price contracts, and fixed-price contracts modified by incentive and penalty provisions. These contracts are undertaken by the Company or its wholly owned subsidiary alone or in partnership with other contractors through joint ventures. The Company also manages, for a fee, construction projects of others.

The length of the Company's contracts varies but is typically about two years. Therefore, assets and liabilities are not classified as current and noncurrent because the contract-related items in the balance sheet have realization and liquidation periods extending beyond one year.

Principles of consolidation. The consolidated financial statements include the Company's majority-owned entities, a wholly owned corporate subsidiary and a 75-percent-owned joint venture (a partnership). All significant intercompany transactions are eliminated. The Company has a minority interest in a joint venture (partnership), which is reported on the equity method.

Revenue and cost recognition. Revenues from fixed-price and modified fixed-price construction contracts are recognized on the percentage-of-completion method, measured by the percentage of labor hours incurred to date to estimated total labor hours for each contract.* This method is used because management considers expended labor hours to be the best available measure of progress on these contracts. Revenues from cost-plus-fee contracts are recognized on the basis of costs incurred during the period plus the fee earned, measured by the cost-to-cost method.

Contracts to manage, supervise, or coordinate the construction activity of others are recognized only to the extent of the fee revenue. The revenue earned in a period is based on the ratio of hours incurred to the total estimated hours required by the contract.

Contract costs include all direct material and labor costs and those indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs, depreciation and interest costs. Selling, general, and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions, and estimated profitability, including those arising from contract penalty provisions, and final contract settlements may result in revisions to costs and income and are recognized in the period in which the revisions are determined. Profit incentives are included in revenues when their realization is reasonably assured. An amount equal to contract costs attributable to claims is included in revenues when realization is probable and the amount can be reliably estimated.

The asset, "Costs and estimated earnings in excess of billings on uncompleted contracts," represents revenues recognized in excess of amounts billed. The liability, "Billings in excess of costs and estimated earnings on uncompleted contracts," represents billings in excess of revenues recognized.

Property and equipment. Depreciation and amortization are provided principally on the straight-line method over the estimated useful lives of the assets. Amortization of leased equipment under capital leases is included in depreciation and amortization.

Interest costs. The Company capitalizes interest costs related to the majority of its construction projects.

*Practice Tip: There are various other alternatives to the percentage of labor hours method for measuring percentage of completion, which, in many cases, may be more appropriate in measuring the extent of progress toward completion of the contract (labor dollars, units of output, and the cost-to-cost method and its variations).

Pension plan. The Company has a defined benefit pension plan covering substantially all employees not covered by union-sponsored plans. Benefits are based on service years and compensation during the last five years of employment. The Company's policy is to fund the costs accrued, subject to the minimum and maximum amounts deductible for income tax purposes, in order to provide benefits earned to date and to be earned in the future.

Income taxes. Deferred income taxes are provided for temporary differences in reporting income for financial statement and tax purposes arising from differences in the methods of accounting for construction contracts and depreciation.

Construction contracts are reported for tax purposes on the completed-contract method and for financial statement purposes on the percentage-of-completion method. Accelerated depreciation is used for tax reporting, and straight-line depreciation is used for financial statement reporting.

2. Contract Receivables

	December 31, 19X8	December 31, 19X7
Contract receivables		
Billed		
Completed contracts	$ 621,100	$ 500,600
Contracts in progress	2,146,100	1,931,500
Retained	976,300	866,200
Unbilled	121,600	105,400
	3,865,100	3,403,700
Less: Allowances for doubtful collections	75,900	69,600
	$3,789,200	$3,334,100

Contract receivables at December 31, 19X8, include a claim, expected to be collected within one year, for $290,600 arising from a dispute with the owner over design and specification changes in a building currently under construction. The changes were made at the request of the owner to improve the thermal characteristics of the building and, in the opinion of counsel, gave rise to a valid claim against the owner.

The retained and unbilled contract receivables at December 31, 19X8, included $38,600 that was not expected to be collected within one year.

3. Costs and Estimated Earnings on Uncompleted Contracts

	December 31, 19X8	December 31, 19X7
Costs incurred on uncompleted contracts	$15,771,500	$12,165,400
Estimated earnings	1,685,900	1,246,800
	17,457,400	13,412,200
Less: Billings to date	17,619,200	13,533,300
	$ (161,800)	$ (121,100)
Included in accompanying balance sheets under the following captions:		
Costs and estimated earnings in excess of billings on uncompleted contracts	$ 80,200	$ 100,600
Billings in excess of costs and estimated earnings on uncompleted contracts	(242,000)	(221,700)
	$ (161,800)	$ (121,100)

4. **Advances to and Equity in Unconsolidated Joint Venture**

The Company has a minority interest (one-third) in a general partnership joint venture formed to construct an office building. All of the partners participate in construction, which is under the general management of the Company. Summary information on the joint venture follows:

	19X8	19X7
Current assets	$ 483,100	$280,300
Construction and other assets	220,500	190,800
	703,600	471,100
Less: Liabilities	236,800	154,000
Net assets	$ 466,800	$317,100
Revenue	$3,442,700	$299,400
Net income	$ 149,700	$ 17,100
Company's interest		
Share of net income	$ 49,900	$ 5,700
Advances to joint venture	$ 50,000	$ 25,000
Equity in net assets	155,600	105,700
Total advances and equity	$ 205,600	$130,700

5. **Transactions With Related Party**

The note receivable, related company, is an installment note bearing annual interest at 9¼%, payable quarterly, with the principal payable in annual installments of $25,000, commencing October 1, 19Y0.

The major Company stockholder owns the majority of the outstanding common stock of this related company, whose principal activity is leasing land and buildings. The Company rents land and office facilities from the related company on a ten-year lease ending September 30, 19Y6, for an annual rental of $19,000.

6. **Property and Equipment**

	December 31, 19X8	December 31, 19X7
Assets		
Land	$ 57,500	$ 57,500
Buildings	262,500	262,500
Shop and construction equipment	827,600	727,600
Automobiles and trucks	104,400	89,100
Leased equipment under capital leases	300,000	300,000
	1,552,000	1,436,700
Accumulated depreciation and amortization		
Buildings	140,000	130,000
Shop and construction equipment	265,600	195,500
Automobiles and trucks	70,000	42,000
Leased equipment under capital leases	100,000	50,000
	575,600	417,500
Net property and equipment	$ 976,400	$1,019,200

7. **Accounts Payable**

Accounts payable include amounts due to subcontractors, totaling $634,900 at December 31, 19X8, and $560,400 at December 31, 19X7, which have been retained pending completion and customer acceptance of jobs. Accounts payable at December 31, 19X8, include $6,500 that are not expected to be paid within one year.

8. Notes Payable

	December 31, 19X8	December 31, 19X7
Unsecured note payable to bank, due in quarterly installments of $22,575 plus interest at 1% over prime	$388,100	$478,400
Note payable to bank, collateralized by equipment, due in monthly installments of $1,667 plus interest at 10% through December 19Y2	80,000	100,000
	$468,100	$578,400

At December 31, 19X8, the payments due totaled $110,300 annually through 19Y2 and $26,900 in 19Y3.

9. Lease Obligations Payable

The Company leases certain specialized construction equipment under leases classified as capital leases. The following is a schedule showing the future minimum lease payments under capital leases by years and the present value of the minimum lease payments as of December 31, 19X8:

Year ending December 31	
19X9	$ 76,500
19Y0	76,500
19Y1	76,500
Total minimum lease payments	229,500
Less: Amount representing interest	31,900
Present value of minimum lease payments	$197,600

At December 31, 19X8, the present value of minimum lease payments due within one year is $92,250. Total rental expense, excluding payments on capital leases, totaled $86,300 in 19X8 and $74,400 in 19X7.

10. Contingent Liability

A claim for $180,000 has been filed against the Company and its bonding company arising out of the failure of a subcontractor of the Company to pay its suppliers. In the opinion of counsel and management, the outcome of this claim will not have a material effect on the Company's financial position, results of operations or cash flows.

11. Pension Plan

Effective as of January 1, 19X7, the Company adopted Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions." Adoption of the statement, which is accounted for prospectively without adjustment to prior years, increased the Company's 19X7 net income by $21,000 ($.07 per share).

A summary of the plan's funding status and the amounts recognized in the consolidated balance sheets follows:

	December 31, 19X8	December 31, 19X7
Actuarial present value of benefit obligations:		
Accumulated benefit obligation, including vested benefits of $38,185 in 19X8 and $37,731 in 19X7	$ 39,307	$ 38,852
Projected benefit obligation for service rendered to date	$ 53,435	$ 55,211
Plan assets at fair value, primarily listed stocks and U.S. government securities	66,695	66,730
Plan assets in excess of projected benefit obligation	(13,260)	(11,519)
Unrecorded net gain (loss) from past experience different from that assumed and effects of changes in assumptions	1,309	(2,753)
Unrecognized net assets at January 1, 19X7, being recognized over 15 years	11,704	13,728
Prepaid pension cost included in prepaid charges and other assets	$ (247)	$ (544)

A summary of the components of pension income follows:

	19X8	19X7
Service cost–benefits earned during the year	$ 2,750	$ 2,007
Interest cost on projected benefit obligation	4,337	3,785
Actual return on plan assets	(2,154)	(8,919)
Net asset gain (loss) deferred for later recognition	(5,009)	2,756
Amortization of unrecognized net asset	(60)	100
Net periodic pension income	$ (136)	$ (271)

The weighted average discount rate and rate of increase in future compensation levels in determining the actuarial present value of the projected benefit obligation were 9% and 6%, respectively. The expected long-term rate of return on assets was 9.5%.

In 19X8 and 19X7, $30,185 and $27,731, respectively, of the vested benefit portion of the projected benefit obligation were settled through the purchase of nonparticipating annuity contracts for certain retired participants and lump sum payments for certain terminated participants. As a result, the Company recognized gains of $627 and $382 in 19X8 and 19X7, respectively.

12. Management Contracts

The Company manages or supervises commercial and industrial building contracts of others for a fee. These fees totaled $121,600 in 19X8 and $1,700 in 19X7 and are included in contract revenues earned.

13. Income Taxes

The provision for income taxes consists of the following:

	19X8	19X7
Currently payable	$451,700	$300,900
Deferred		
Contract related	204,200	(80,900)
Property and equipment related	7,000	5,000
	$662,900	$225,000

The components of the balance of deferred income taxes were:

	December 31, 19X8	December 31, 19X7
Contract related	$594,000	$389,800
Property and equipment related	25,200	18,200
	$619,200	$408,000

A reconciliation of the statutory federal tax rate to the effective tax rate on pretax income is as follows:

	19X8	19X7
Statutory federal tax rate	40.0%	46.0%
Contract related	10.6	8.7
Depreciation	3.2	3.0
State and local taxes, less federal tax effect	1.5	(3.6)
Other	(3.9)	(4.7)
Total effective tax rate	51.4%	49.4%

14. Backlog

The following schedule shows a reconciliation of backlog representing signed contracts, excluding fees from management contracts, in existence at December 31, 19X7 and 19X8:

Balance, December 31, 19X7	$24,142,600
Contract adjustments	1,067,100
New contracts, 19X8	3,690,600
	28,900,300
Less: Contract revenue earned, 19X8	22,432,500
Balance, December 31, 19X8	$ 6,467,800

In addition, between January 1, 19X9, and February 18, 19X9, the Company entered into additional construction contracts with revenues of $5,332,800.

15. Noncash Investing and Financing Activities

In 19X8 and 19X7 respectively, the Company purchased equipment on open account amounting to $ ______ and $ ______ , and incurred capitalized lease obligations for new equipment amounting to $ ______ and $ ______ .

16. Major Customers and Risk Concentrations

In 19X8 and 19X7 respectively, two and three customers accounted for 56% and 48% of contract revenues earned.

The Company grants credit, generally without collateral, to its customers, which are located primarily in the New England area. Management believes that its contract acceptance, billing and collection policies are adequate to minimize potential credit risk. At December 31, 19X8, real estate operators, manufacturers and others, respectively, accounted for 62%, 30% and 8% of contract receivables, and 45%, 33% and 22% of costs and estimated earnings on uncompleted contracts. In 19X8 and 19X7, respectively, 52% and 47% of contract revenues were earned from Connecticut sources.

The Company is exposed to credit loss in the event of nonperformance by its subcontractors. At December 31, 19X8, the Company was contingently liable under guarantees of certain subcontractors' obligations maturing in 19X9 and aggregating $479,000, including a Connecticut subcontractor's obligations amounting to $298,000.

ILLUSTRATIVE ADDITIONAL INFORMATION
Percentage of Completion

Independent Auditor's Report on Additional Information

The Shareholders and Board of Directors
Percentage Contractors, Inc.

Our audits of the basic financial statements presented in the preceding section of this report were made primarily to form an opinion on such financial statements taken as a whole. The additional information, contained in the following schedules 1 through 3, is not considered essential for the fair presentation of the financial position of Percentage Contractors, Inc., the results of its operations, or its cash flows in conformity with generally accepted accounting principles. However, the data were subjected to the audit procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*City, State*]*
February 18, 19X9

*Optional for non-public companies.

Percentage Contractors, Inc.
Schedule 1
Earnings from Contracts

Years Ended December 31, 19X8 and 19X7

	19X8 Revenues earned*	19X8 Cost of revenues earned	19X8 Gross profit (loss)	19X7 Gross profit (loss)
Contracts completed during the year	$ 6,290,800	$ 5,334,000	$ 956,800	$ 415,300
Contracts in progress at year-end	16,141,700	14,636,900	1,504,800	921,400
Management contract fees earned	121,600	51,800	69,800	1,700
Unallocated indirect and warranty costs		46,700	(46,700)	(38,100)
Minority interest in joint venture		128,000	(128,000)	(26,200)
Charges on prior year contracts		162,000	(162,000)	
	$22,554,100	$20,359,400	$2,194,700	$1,274,100

Percentage Contractors, Inc.
Schedule 2
Contracts Completed

Year Ended December 31, 19X8

Contract		Contract totals			Before January 1, 19X8			During the year ended December 31, 19X8		
Number	Type	Revenues earned	Cost of revenues	Gross profit (loss)	Revenues earned	Cost of revenues	Gross profit (loss)	Revenues earned	Cost of revenues	Gross profit (loss)
1511	B	$ 5,475,300	$ 4,802,500	$ 672,800	$3,223,400	$2,932,700	$290,700	$2,251,900	$1,869,800	$382,100
1605	A	695,000	880,900	(185,900)	596,100	558,100	38,000	98,900*	322,800	(223,900)
1624	A	140,700	150,700	(10,000)	29,600	31,800	(2,200)	111,100	118,900	(7,800)
1711	A	2,725,100	2,391,700	333,400	1,654,100	1,510,000	144,100	1,071,000	881,700	189,300
1791	B	4,770,100	4,288,900	481,200	3,028,500	2,929,600	98,900	1,741,600	1,359,300	382,300
1792	A	635,000	457,900	177,100				635,000	457,900	177,100
Small contracts		413,400	349,500	63,900	32,100	25,900	6,200	381,300	323,600	57,700
		$14,854,600	$13,322,100	$1,532,500	$8,563,800	$7,988,100	$575,700	$6,290,800	$5,334,000	$956,800

Contract types
A—Fixed-price.
B—Cost-plus-fee.

*During 19X8, revenues earned were reduced by $150,000 under penalty clauses which included contract number 1605 in the amount of $135,000.

Percentage Contractors, Inc.
Schedule 3
Contracts in Progress

December 31, 19X8

Contract		Total contract		From inception to December 31, 19X8						At December 31, 19X8		For the year ended December 31, 19X8		
Number	Type	Revenues	Estimated gross profit (loss)	Revenues earned	Total costs incurred	Cost of revenues	Gross profit (loss)	Billed to date	Estimated cost to complete	Costs and estimated earnings in excess of billings	Billings in excess of costs and estimated earnings	Revenues earned	Cost of revenues	Gross profit (loss)
1845	A	$ 6,750,200	$ 877,000	$ 5,890,500	$ 5,244,500	$ 5,143,900	$ 746,600	$ 5,976,000	$ 628,700	$15,100		$ 5,664,200	$ 4,984,500	$ 679,700
1847	B	1,471,800	127,100	1,250,400	1,139,800	1,139,800	110,600	1,195,800	204,900	54,600		962,800	899,000	63,800
1912	A	451,800	(130,100)	108,600	238,700	238,700	(130,100)	98,100	343,200	10,500		98,600	191,500	(92,900)
1937	B	11,125,000	847,900	7,337,900	7,045,500	6,721,100	616,800	7,808,000	3,231,600		$145,700	6,981,900	6,469,900	512,000
1945	A	3,650,100	497,000	2,395,200	2,061,300	2,061,300	333,900	2,491,500	1,091,800		96,300	2,395,200	2,061,300	333,900
Small contracts		51,300	8,400	49,800	41,700	41,700	8,100	49,800	1,200			39,000	30,700	8,300
		$23,500,200	$2,227,300	$17,032,400	$15,771,500	$15,346,500	$1,685,900	$17,619,200	$5,501,400	$80,200	$242,000	$16,141,700	$14,636,900	$1,504,800

Contract types
A—Fixed-price.
B—Cost-plus-fee.

ILLUSTRATIVE FINANCIAL STATEMENTS
Completed Contracts

The Stockholders and Board of Directors
Completed Contractors, Inc.

We have audited the accompanying balance sheets of Completed Contractors, Inc. as of December 31, 19X8 and 19X7, and the related statements of income and retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Completed Contractors, Inc. as at December 31, 19X8 and 19X7, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*City, State*]*
February 18, 19X9

*Optional for non-public companies.

Completed Contractors, Inc.
Balance Sheets

December 31, 19X8 and 19X7

	19X8	19X7
Assets		
Current assets		
Cash	$ 242,700	$ 185,300
Contract receivables (less allowance for doubtful accounts of $10,000 and $8,000)	893,900	723,600
Costs in excess of billings on uncompleted contracts	418,700	437,100
Inventories	463,600	491,300
Prepaid expenses	89,900	53,900
Total current assets	2,108,800	1,891,200
Cash value of life insurance	35,800	32,900
Property and equipment, at cost		
Building	110,000	110,000
Equipment	178,000	163,000
Trucks and autos	220,000	200,000
	508,000	473,000
Less accumulated depreciation	218,000	203,200
	290,000	269,800
Land	21,500	21,500
	311,500	291,300
	$2,456,100	$2,215,400

	19X8	19X7
Liabilities and Stockholders' Equity		
Current liabilities		
Current maturities, long-term debt	$ 37,000	$ 30,600
Accounts payable	904,900	821,200
Accrued salaries and wages	138,300	155,100
Accrued income taxes	53,000	36,200
Accrued and other liabilities	116,400	55,550
Billings in excess of costs on uncompleted contracts	34,500	43,700
Total current liabilities	1,284,100	1,142,350
Long-term debt, less current maturities	245,000	241,000
	1,529,100	1,383,350
Stockholders' equity		
Common stock—$10 par value, 50,000 authorized shares, 23,500 issued and outstanding shares	235,000	235,000
Additional paid-in capital	65,000	65,000
Retained earnings	627,000	532,050
Total stockholders' equity	927,000	832,050
	$2,456,100	$2,215,400

The accompanying notes are an integral part of these financial statements.

Completed Contractors, Inc.
Statements of Income and Retained Earnings

Years Ended December 31, 19X8 and 19X7

	19X8	19X7
Contract revenues	$9,487,000	$8,123,400
Costs and expenses		
Cost of contracts completed	8,458,500	7,392,300
General and administrative expenses	684,300	588,900
Interest expense	26,500	23,000
	9,169,300	8,004,200
Income before income taxes	317,700	119,200
Income taxes	164,000	54,200
Net income ($6.54 and $2.77 per share)	153,700	65,000
Retained earnings		
Balance, beginning of year	532,050	525,800
Dividends paid ($2.50 per share)	(58,750)	(58,750)
Balance, end of year	$ 627,000	$ 532,050

The accompanying notes are an integral part of these financial statements.

Completed Contractors, Inc.
Statements of Cash Flows
(Indirect Method)

Years Ended December 31, 19X8 and 19X7
Increase (Decrease) in Cash

	19X8	19X7
Cash flows from operating activities		
Net income	$ 153,700	$ 65,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	54,800	50,300
Increase in contract receivables	(170,300)	(36,500)
Decrease (increase) in costs in excess of billings on uncompleted contracts	18,400	(49,100)
Decrease (increase) in inventories	27,700	(3,400)
Decrease (increase) in prepaid expenses	(36,000)	16,500
Increase in accounts payable	83,700	24,600
Increase (decrease) in accrued salaries and wages	(16,800)	24,300
Increase (decrease) in accrued income taxes	16,800	(6,300)
Increase (decrease) in accrued and other liabilities	60,850	(33,100)
Decrease in billings in excess of costs on uncompleted contracts	(9,200)	(16,300)
Net cash provided by operating activities	183,650	36,000
Cash flows from investing activities		
Purchase of property and equipment	(75,000)	(53,500)
Increase in cash value of life insurance	(2,900)	(2,685)
Net cash used in investing activities	(77,900)	(56,185)
Cash flows from financing activities		
Proceeds from issuance of long-term debt	44,000	68,000
Principal payments on long-term debt	(33,600)	(15,500)
Cash dividends paid	(58,750)	(58,750)
Net cash used in financing activities	(48,350)	(6,250)
Net increase (decrease) in cash	57,400	(26,435)
Cash, beginning of year	185,300	211,735
Cash, end of year	$ 242,700	$ 185,300

The accompanying notes are an integral part of these financial statements.

Supplementary data:		
Interest paid	$ 27,300	$ 23,200
Income taxes paid	$ 147,200	$ 60,500

Completed Contractors, Inc.
Notes to Financial Statements

Years Ended December 31, 19X8 and 19X7

Significant Accounting Policies

Company's activities. The Company is a heating and air-conditioning contractor for residential and commercial properties. Work on new structures is performed primarily under fixed-price contracts. Work on existing structures is performed under fixed-price or time-and-material contracts.

Revenue and cost recognition. Revenues from fixed-price construction contracts are recognized on the completed-contract method. This method is used because the typical contract is completed in two months or less and financial position and results of operations do not vary significantly from those which would result from use of the percentage-of-completion method. A contract is considered complete when all costs except insignificant items have been incurred and the installation is operating according to specifications or has been accepted by the customer.

Revenues from time-and-material contracts are recognized currently as the work is performed.

Contract costs include all direct material and labor costs and those indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs, and depreciation costs. Selling, general and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Claims are included in revenues when received.

Costs in excess of amounts billed are classified as current assets under costs in excess of billings on uncompleted contracts. Billings in excess of costs are classified under current liabilities as billings in excess of costs on uncompleted contracts. Contract retentions are included in accounts receivable.

Inventories. Inventories are stated at cost on the first-in, first-out basis using unit cost for furnace and air-conditioning components and average cost for parts and supplies. The carrying value of furnace and air-conditioning component units is reduced to realizable value when such values are less than cost.

Property and equipment. Depreciation is provided over the estimated lives of the assets principally on the declining-balance method, except on the building where the straight-line method is used.

Pension plan. The Company has a defined benefit pension plan covering substantially all employees not covered by union-sponsored plans. Benefits are based on service years and compensation during the last five years of employment. The Company's policy is to fund the costs accrued, subject to the minimum and maximum amounts deductible for income tax purposes, in order to provide benefits earned to date and to be earned in the future.

Contract Receivables

	December 31, 19X8	December 31, 19X7
Completed contracts, including retentions	$438,300	$408,600
Contracts in progress		
Current accounts	386,900	276,400
Retentions	78,700	46,600
	903,900	731,600
Less: Allowance for doubtful accounts	10,000	8,000
	$893,900	$723,600

Retentions include $10,300 in 19X8, which are expected to be collected after 12 months.

Costs and Billings on Uncompleted Contracts

	December 31, 19X8	December 31, 19X7
Costs incurred on uncompleted contracts	$2,140,400	$1,966,900
Billings on uncompleted contracts	1,756,200	1,573,500
	$ 384,200	$ 393,400
Included in accompanying balance sheets under the following captions:		
Costs in excess of billings on uncompleted contracts	$ 418,700	$ 437,100
Billings in excess of costs on uncompleted contracts	(34,500)	(43,700)
	$ 384,200	$ 393,400

Inventories

	December 31, 19X8	December 31, 19X7
Furnace and air-conditioning components	$303,200	$308,700
Parts and supplies	160,400	182,600
	$463,600	$491,300

Furnace and air-conditioning components include used items of $78,400 in 19X8 and $71,900 in 19X7 that are carried at realizable value, which is lower than cost.

Income Taxes

A reconciliation of the statutory federal tax rate to the effective tax rate on pretax income is as follows:

	Year Ended December 31, 19X8	19X7
Statutory federal tax rate	40.0%	46.0%
State and local taxes, less federal effect	11.4	4.4
Other	.2	(4.9)
Total effective tax rate	51.6%	45.5%

Long-Term Debt

	December 31, 19X8	December 31, 19X7
Notes payable, bank		
Notes due in quarterly installments of $2,500, plus interest at 8%	$140,000	$150,000
Notes due in monthly installments of $1,500, plus interest at prime plus 1½%	87,000	58,000
Mortgage payable		
Due in quarterly payments of $3,500, including interest at 9%	55,000	63,600
	282,000	271,600
Less: Current maturities	37,000	30,600
	$245,000	$241,000

As of December 31, 19X8, long-term debt matures as follows:

19X9	$ 37,000
19Y0	38,000
19Y1	39,000
19Y2	40,000
19Y3	37,000
Thereafter through 19Y5	91,000
	$282,000

Pension Plans

Effective as of January 1, 19X7, the Company adopted Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions." Adoption of the statement, which is accounted for prospectively without adjustment to prior years, increased the Company's 19X7 net income by $21,000 ($.89 per share).

A summary of the plan's funding status and the amounts recognized in the consolidated balance sheet follows:

	December 31,	
	19X8	19X7
Actuarial present value of benefit obligations:		
Accumulated benefit obligation, including vested benefits of $38,185 in 19X8 and $37,731 in 19X7	$ (39,307)	$ (38,852)
Projected benefit obligation for service rendered to date	$ (53,435)	$ (55,211)
Plan assets at fair value, primarily listed stocks and U.S. government securities	66,695	66,730
Plan assets in excess of projected benefit obligation	13,260	11,519
Unrecorded net loss (gain) from past experience different from that assumed and effects of changes in assumptions	(1,309)	2,753
Unrecognized net assets at January 1, 19X7, being recognized over 15 years	(11,704)	(13,728)
Prepaid pension cost included in prepaid expenses	$ 247	$ 544

A summary of the components of pension income follows:

	19X8	19X7
Service cost—benefits earned during the year	$ 2,750	$ 2,007
Interest cost on projected benefit obligation	4,337	3,785
Actual return on plan assets	(2,154)	(8,919)
Net asset gain (loss) deferred for later recognition	(5,009)	2,756
Amortization of unrecognized net asset	(60)	100
Net periodic pension income	$ (136)	$ (271)

The weighted average discount rate and rate of increase in future compensation levels in determining the actuarial present value of the projected benefit obligation were 9% and 6%, respectively. The expected long-term rate of return on assets was 9.5%.

In 19X8 and 19X7, $30,185 and $27,731, respectively, of the vested benefit portion of the projected benefit obligation were settled through the purchase of nonparticipating annuity contracts for certain retired participants and lump sum payments for certain terminated participants. As a result, the Company recognized gains of $627 and $382 in 19X8 and 19X7, respectively.

Backlog

The estimated gross revenue of work to be performed on signed contracts was $4,691,000 at December 31, 19X8, and $3,617,400 at December 31, 19X7. In addition to the backlog of work to be performed, there was gross revenue, to be reported in future periods under the completed-contract method used by the Company, of $2,460,000 at December 31, 19X8, and $2,170,000 at December 31, 19X7.

Risk Concentrations

The Company's contract revenues and receivables, and costs on uncompleted contracts, are each divided approximately equally between residential and commercial sources, which are primarily located within 50 miles of its home office in Cocoloco, Connecticut. The Company generally requires a deposit of up to 20% of the contract price before commencing work, and bills the balance upon completion.

TECHNICAL HOTLINE

The AICPA Technical Information Service answers inquiries about specific audit or accounting problems.

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